one or another city, county, school, road or drainage district. The State itself through a special agency is contemplating the issuance of $2,000,000.00 bonds for flood control in the Everglades, and such issue is necessary to enable the State to secure Federal aid in such work under Rivers and Harbors Act of Congress 1930. In Florida, as in other states, financing is not only necessary for many pressing improvements but it is immediately desirable to relieve unemployment caused by the present depression.

The question at issue is the validity of a tax (in form of income tax) sought to be imposed on dealers in state and municipal obligations, which tax is measured by the interest paid by dealers in carrying such obligations. The states and municipalities are materially affected by this discriminative tax burden. The instrumentalities of the states and their taxpayers bear the burden or receive the benefit, as the case may be, of any tax or tax exemption so directly affecting the marketing of their bonds.

The so-called dealers in municipal securities constitute the original distributing market for all state and municipal bonds. This business is competitive. The great majority of bonds are sold on competitive bidding by dealers located in all the larger cities of the country. The bonds so purchased are normally purchased and carried on moneys borrowed at the banks pending their distribution to investors. The cost of carrying them is affected by the money markets and particularly by the varying interest rates paid in carrying securities. This expense of carrying bonds is a large factor in determining the profit or loss of dealers in municipal markets and anything in the nature of a tax upon this interest

naturally increases the cost and burdens the distribution of the bonds and encourages or discourages dealers in engaging in such business and also in bidding on particular bonds in particular markets. It discourages competition and is a burden upon the states and municipalities by diminishing the price received upon their bonds.

When interest rates are high, as in 1928 and 1929, many dealers, because of such rates and also because of the adverse factor of tax upon the interest paid, withdraw from the municipal market and engage in the distribution of other securities, including corporate stocks, dividends upon which when received by dealers, pending distribution, are partially—and in the case of corporate dealers wholly—exempt from taxation, although the interest paid in carrying such securities is deductible from the gross income of the dealers.

Because of this very direct and discriminative burden and its necessary effect in times of stress in the marketing of state and municipal bonds, present counsel have asked leave to file this brief.

The states as well as the federal government have a governmental interest in the far-reaching constitutional question raised by the petition and in the lower court opinion. Both parties to this appeal are asking the Court to decide this question, but we do not believe that this question need be decided in this case. We submit that the Revenue Act of 1921 properly construed did not impose the tax in question. Section 214 (a) of the Revenue Act of 1921, provided the following deductions:

> "(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. * * *

> (2) All the interest paid or accrued within the taxable year on indebtedness, *except on indebtedness incurred or continued to purchase or carry obligations or securities * * * the interest upon which is wholly exempt from taxation under this title.*"

and others not now in question.

The petition in this case and the opinions below are directed to an attack upon the constitutionality of the exception in paragraph (2), which we have italicized.

We wish to submit to the Court that the interest sought to be deducted in this case was an ordinary and necessary expense of petitioner's business, as appears from the petition, and was therefore properly deductible under paragraph (1).

2. George B. Gibbons & Company, Inc., is a dealer in municipal securities, and the petitioner in a suit now pending in the Court of Claims, to recover taxes paid for the years 1926, 1927 and 1928, presenting substantially the same questions, except as indicated, as the questions here at issue. We present herewith printed copies of the petition in the Gibbons case from which it will appear that the petitioner in that case claims to have deducted interest paid under the paragraph covering the deduction of business expenses, and not under the paragraph permitting the deduction of interest paid outside of any business.

Present counsel are joining in this brief to avoid duplication and expense and to emphasize to the Court the identity of interest between the states and the municipalities issuing securities and the dealers who handle their securities in opposing what we believe to be a discriminative burden sought to be im-

posed by the Federal government upon the normal marketing of such securities.

POINT I.

A FEDERAL TAX OR BURDEN DISCRIMINATIVE IN ITS EFFECT UPON THE MARKETING OF STATE AND MUNICIPAL OBLIGATIONS IS UNCONSTITUTIONAL.

1. The respondent's petition attacks the validity of the prohibition in paragraph (2) of Section 214 (a) of the Revenue Act of 1921 against the deduction of interest paid on indebtedness incurred to purchase state and municipal bonds. While we do not believe this prohibition applies to the petitioner (Point II), the question has been considered and decided by the Court below and is presented on this appeal.

The question is too serious in its implications to be ignored by counsel representing the states.

If this and similar provisions in the several revenue acts specifically discriminating against state and municipal bonds are upheld, a most anomalous result will have been achieved. *The discriminatory tax will be valid. The non-discriminatory tax invalid.* A tax on net income is unconstitutional under the decision if and in so far as interest from muncipal bonds is included in arriving at the net income, although by analogy with the excise tax decisions it is clear that the tax, not being on gross income, is not on the interest received as such and is in no way a specific tax on such interest, while on the other hand a specific provision adding to the net income as otherwise determined the amount not of interest received or other income, but of an essential and very heavy expense

incurred in carrying municipal bonds, though in terms and effect a direct and special burden on the marketing, purchasing or carrying of such bonds, is, it is now claimed, constitutional.

In principle and of necessity it seems to us that this question, when presented, can only be decided against the government.

> *National Life Insurance Co. v. U. S.*, 277 U. S. 508 and cases cited.
> *Macallen Co. v. Massachusetts*, 279 U. S. 620.
> *U. S. Glue Co. v. Oak Creek*, 247 U. S. 321-329, and
> *Peck v. Lowe*, 247 U. S., 165 at page 174.

In the last named case, referring to the income tax as affecting an exporter, the Court said, "It is not laid on income from exportation because of its source, or in a discriminative way, but just as it is laid on other income. The words of the Act are: 'net income arising or accruing from all sources.' *There is no discrimination.*" (Italics ours)

It was of course the fact that there was no discrimination that enabled the Court to sustain the income tax as applied to an exporter and to distinguish its decision from *Brown v. Maryland*, 12 Wheat. 419, where a license tax on the business of an exporter was held to be in effect a tax upon exports.

The present tax, though arrived at under the guise of an additional tax on net income, is in its ordinary application a tax solely on those dealing in state and municipal bonds, measured by the interest paid in carrying such bonds. It is the substance and effect that controls.

In the dissenting opinion in the National Life

Insurance Company case, Mr. Justice Brandeis (531) quoted the distinguished counsel for the amici curiae:

> "This allowance of a deduction of a fixed percentage, or 4 per cent of the mean of the reserve, itself points to the nature of the deduction, *not as a right, but as a favor.*" (Italics ours.)

In the present instance the deduction to which the limitation is sought to be applied is "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," or as it was considered below, "interest paid or accrued within the taxable year on indebtedness" incurred in respondent's business.

Neither of these deductions can be said to be a favor under the principle and terms of the revenue act.

2. *The tax exempt character of state and municipal bonds, can be wholly destroyed if the present tax is upheld.* This Court, speaking by Mr. Justice McReynolds, has said:

> "The suggestion that as Congress may or may not grant deductions from gross income at pleasure, it can deny to one and give to another is specious, but unsound. The burden from which federal and state obligations are free is the one laid upon other property. To determine what this burden is requires consideration of the mode of assessment, including, of course, deductions from gross values. What remains after subtracting all allowance is the thing really taxed."

National Life Insurance Company, *supra,* page 520.

The object sought to be reached by the tax provi-

sion held invalid in that case and the object sought to be reached in the present case can in fact be reached in a variety of ways if this Court will permit the ingenuity of the legislature to override the constitutional inhibition. We do not believe that this Court will throw open the door to Federal taxation, discriminatory in character and discriminative in effect upon the instrumentalities of the states while at the same time as in its most recent decision (Macallen v. Massachusetts) protecting Federal instrumentalities and obligations from a non-discriminative burden or tax by state legislatures. If the Federal power extends to discriminative burdens, designed to offset constitutional inhibitions protecting state agencies and instrumentalites, then the corresponding power of the state must be equal to that of the Federal government.

It was, we understand, proposed some years ago, that the Congress might leave the income tax rates at their war levels, and *by separate act* "permit" taxpayers to make a "voluntary" return of interest received from state and municipal bonds, in which event the tax under the basic law should be limited to a lower named per cent flat or graduated, of the sum of (a) net income as returned and (b) tax free interest "voluntarily returned." The effect of such a proposal, if enacted and upheld, would be to *compel* the "voluntary" inclusion of interest of state and municipal bonds as a part of gross income.

Unless the constitutional inhibition, resting on the decisions of this court and upon the fundamental conceptions of our dual sovereignty, is a mere fiction, it cannot be evaded by a statute which while avoiding the appearance of a tax in fact levies a tax

upon the very thing that is and must be exempt. The unwritten constitutional principle looks to the substance. From its nature, it cannot be evaded by the written statute, however ingenious. *The governments, not the taxpayer, are primarily concerned in this matter.*

In the Macallen case, *supra*, at page 624, this Court quoted from Chief Justice Marshall in *Weston v. Charleston*, 2 Pet. 449, 468, a principle which "has never since been departed from by this Court,"

> "The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence upon the contract. The extent of this influence depends on the will of a distinct government; to any extent, however, inconsiderable, it is a burden on the operations of government. It may be carried to an extent that will arrest them entirely."

Present counsel can see the practical aspects and value of such "permissive" deductions or limitations, granted "*not as a right, but as a favor.*" The same result would be effected in several ways. However effected, the burden upon the instrumentalities of the states and the corresponding state burdens upon federal instrumentalities, may be made precisely what it would be if the interest on their obligations were required to be included as gross income under the primary or basic provisions of the law. It is that burden, regardless of its form or of the ingenuity of legislation, against which this Court has heretofore protected the instrumentalities of the federal and state governments.

We respectfully submit, that independently of any

question of the validity of a general tax, state or federal, which includes or reaches municipal interest or other tax exempt income, there is no question, or should be none, that a discriminative burden, however effected, e. g. by inheritance or other excise tax, attempted to be laid by one government upon the officers, agencies, contracts, obligations or other operations or instrumentalities of the other, is unconstitutional. Macallen v. Mass., *supra.*

POINT II.

THE LAW PERMITS THE DEDUCTION OF INTEREST PAID BY A DEALER ON MONEYS BORROWED TO CARRY MUNICIPALS.

1. Paragraph (1) of Section 214 (a) authorizes the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." There is no limitation to this deduction. Under the plain reading of this paragraph a dealer is permitted to deduct interest paid as an expense of the business. The law, or any doubt in the law, is not to be construed in favor of the taxpayer, and the tax sought to be imposed must be within both the letter and the intent of the law. *U. S. v. Wigglesworth*, 2 Story 369, *Gould v. Gould*, 245 U. S. 151, 153, and cases cited, *Reinecke v. Trust Company*, 278 U. S. 339, 348.

It appears from the transcript that the respondent is a dealer in municipal bonds and that the interest sought to be deducted was in fact an "ordinary and necessary expense" of such business. The respondent deducted such interest in its original return. It was not necessary for the respondent in this case to attack the validity of the limitation against the

deduction of interest under paragraph (2). That paragraph applies only to the deduction of interest "on personal indebtedness as distinguished from business indebtedness"—we quote from the "instructions" found on page 3 of Form 1040 for the return of individual income for the year 1929. Despite its anomalous position on this appeal, the Internal Revenue Bureau has consistently followed the correct view of the law in the form used for the return of net income.

On the first page of the last prescribed form (No. 1040) of individual tax return for the year 1929, under "INCOME" we find

"2. Income from Business or Profession $....."
(From Schedule A)

Under "DEDUCTIONS" we find

"13. Interest Paid $.....
14. Taxes Paid $....."

On the second page we find

"SCHEDULE A—INCOME FROM BUSINESS OR PROFESSION
(See Instruction 2)",

under which, after "total receipts", cost of goods sold", etc., we find:

"Other Business Deductions

11. *Interest on business indebtedness to others,* $.....
12. *Taxes on business and business property,* $.....

and finally:

"19. Net profit * * * (enter as Item 2) $....."

On the third page entitled

"INSTRUCTIONS", we read,

"The Instructions Numbered on this page correspond with the *item numbers* on the first page of the return."

Under

"2. Income from Business or Profession", referring to Schedule A. we note:

"Enter on *line* 11 interest on business indebtedness to others. *Do not include* interest to yourself" etc.

We do *not* find any instruction "do not include" interest on indebtedness incurred to purchase tax-free obligations.

At this point, it is clear that the taxpayer, following the instructions, has made a complete deduction of *all* interest paid on business indebtedness.

Under "13. Interest paid", we read:

"*Enter as item 13 interest paid on personal indebtedness as distinguished from business indebtedness (which should be deducted under Schedule A or B). Do not include interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation.*" (Italics ours.)

Schedule B covers "rents and royalties", as to which also of course there may be interest paid.

In other words the Bureau itself in its prescribed form recognizes and requires the necessary distinction to be made between interest paid on business indebtedness under Schedule A including the deductions authorized by paragraph (1) of the law, and interest paid on "personal indebtedness" under Item 13, the deduction allowed by paragraph (2) of the law. There is no restriction on the deduction of interest paid on business indebtedness under Schedule A. This restriction is found only under Item 13 and affects only the deduction of "interest paid on personal indebtedness as distinguished from business indebtedness." Likewise, of course, "taxes paid" on business indebtedness are deductible under Schedule A, *i. e.*, under paragraph (1) and taxes deductible under "item 13", *i. e.*, the separate paragraph (3), include only taxes on property not used in business.

Substantially the same form and instructions were used for the year 1922, presumably by the taxpayer in the present case.

Clearly, if the position contended for on this appeal is correct, the required form of return is wrong. It is wrong and confusing not only in detail, but in requiring a separate statement of business income. If interest can only be deducted under paragraph (2), and taxes under paragraph (3), then any business income sought to be arrived at under Schedule A must be partial and fictitious. Only that which has the nature of income can be taxed and "the construction of the act (is) inseparable from the interpretation of the Sixteenth Amendment." *Eisner v. Macomber*, 252 U. S., 189, 202; *Doyle v. Mitchell*, 247 U. S. 179.

The allowance of the deduction of all interest as an

expense of the business under paragraph (1) is not only within the plain reading of the law. It is in keeping with the principle and purpose of the law, to tax net income, saving only that which is not constitutionally taxable. Any other reading of the law would, in the case of a dealer, levy a tax on interest paid to offset, it would seem, the exemption allowed on interest received. It would not, as in the case of "interest paid on personal indebtedness", *i. e.*, outside of a normal business, be directed to the deliberate avoidance of the tax on otherwise taxable income.

The Government's position is that the limitation in paragraph (2) applies to paragraph (1) by analogy with the operation of clauses first and third in the second paragraph of Section 38 of the Corporation Tax Act of 1909, as applied in *Anderson v. Forty-two Broadway Company*, 239 U. S. 69, page 71. The "special circumstances" under the 1909 Act had reference in part to a clause not found in the revenue acts. The resemblance of the 1921 paragraphs to the 1909 clauses is more apparent than real, even if we ignore the fact that we are now dealing with a tax on all incomes, individual and corporate, where the purpose and interpretation of the act follow the power under the XVIth amendment, and not solely with a corporation excise tax under the plenary power. The only business expenses deductible under the first clause in the 1909 Act were those paid "*in the maintenance and operation of its business and properties*" and the added clause, "including all charges such as rentals or franchise payments" etc., emphasized the purpose of the clause to reach what is generally recognized as "operating income." The separate interest deduction "*on bonded* and other indebtedness not exceeding the paid-up capital

stock" could have had no effect at all unless as this Court held in the Forty-two Broadway case it applied to bonded debt and, as the Court seemed to consider, was directed in purpose and principle to interest on indebtedness in the nature of capital indebtedness, and designed to make the tax reach a corporation which with a huge debt and small capital was in fact "conducted more for the benefit of the creditors than of the stockholders." The purpose of the act was plain and beneficial, to prevent the avoidance of the tax. This was no longer possible when both corporate income and individual income became taxable under the same law. The interpretation urged by the taxpayer under the 1909 act would, of course, have enabled the owners of a corporation to avoid the tax by doing business on money loaned to it by themselves.

We do not believe that the reading and necessary intent of the 1909 act will be held to control the interpretation of the later revenue acts which beginning with 1913 were new enactments under the new constitutional amendment. In particular the limitation in clause first, "in the *maintenance and operation* of *its business*" found in the corporation act of 1909 in connection with the separate deductions there specified, cannot be read into paragraph (1) of the individual deduction sections of the revenue acts where the phrase is *broad and general "in carrying on any trade or business"* and plainly, as evidenced by Form 1040, permits the complete deduction of all business expenses including interest. More could be said on this, but it seems clear that the very special purpose of the 1909 act, properly upheld in the Forty-two Broadway case, has long since been served, and that the later provision now found in the revenue acts

of 1921 and later years should be given their natural interpretation. To hold otherwise in this case is to tax something that is not income and has not the nature of income,—the interest paid by dealers in carrying bonds for sale.

2. To hold that interest paid cannot be deducted under paragraph (1) raises a constitutional question of great difficulty. This question should be avoided. We have covered it under Point I. We wish, however, to point out the important distinction in the limitation as applied to a dealer. A careful reading of the opinion below, particularly the statement in the final paragraph, that "such disallowance", of the deduction of interest under paragraph (2) "cannot be given effect in the present case", indicates that the Court read into paragraph (2) a constitutionally necessary exception where there was no purpose of tax avoidance. In his brief supporting petition for writ the Attorney General said that the restriction "is justified by the practical necessity of preventing such borrowings for the purpose of evading the tax on other income." For argument, it might be conceded that the limitation in paragraph (2) could be upheld as a quasi penal provision, applied and limited to the purchase of tax-free bonds on borrowed money for the deliberate purpose of avoiding the income tax. An investor or speculator with an otherwise taxable income of $50,000, may conceivably carry $1,000,000 4% tax-free bonds on borrowed money, paying $50,000 interest. Under very favorable circumstances he might carry $2,000,000 with a tax-free income of $80,000 and pay 2% to 3% and have both a profit on the transaction and no tax to pay on his otherwise taxable income. The more instances we assume,

however, the less feasible in practice such tax avoidance appears except perhaps under very high tax rates. The trouble, cost and risk are deterrent. But in theory the chance of tax avoidance is there and it may be would justify some possible provision to prevent it. It is notorious that the present provision is readily evaded by wealthy investors; *e. g.*, they can borrow money on railroad bonds or real estate and buy municipal bonds. Such tax avoidance can be readily effected to day by carrying preferred and common stocks on borrowed money, but we doubt if many taxpayers purposely avail themselves of it.

But such is not the state of facts in the present suit. We have to do with the operation of the law and constitutional inhibition as applied to an active dealer engaged in a normal and necessary business, a business essential to the advantageous marketing of state and municipal bonds. There is no suggestion of tax avoidance, but of whether or not the Congress has, in the case of the dealer, intended to tax interest paid, or can tax it constitutionally, simply to offset the exemption on tax-free interest received resulting from the constitutional inhibition.

As applied to such normal business, the constitutional tax exempt character of municipals is, as in the case of the investor purchasing for investment (not on borrowed money) a normal and necessary result of the constitutional inhibition. There is no attempt at tax avoidance. Tax immunity, partial or entire, of a dealer, results from the constitutional inhibition, from its necessary application to a business so directly concerned with the marketing of state securities. Whatever tax avoidance or escape

from tax results to the dealer, there is in fact or by presumption no resort to a device to avoid the tax.

Also, as in the case of the investor, the benefit or burden enures to the states and their subdivisions, a fact to be presumed in view of the very special character and heavy incidence of the tax and the extremely competitive nature of the business; the tax or tax saving is a factor which can be measured on every purchase.

As stated, the incidence of this tax, as claimed, lying directly upon the amount of interest paid, falls upon a normal business essential to the successful marketing and competitive distribution of state and municipal obligations. As to this business, the tax is definitely discriminatory, in terms and in effect. In passing, the Court will note that dealers buying and selling stocks of corporations, common and preferred, are partly—*corporate dealers wholly*—exempt from any tax on dividends received while the stocks are carried—1928 Act, Sec. 23(p) and 25(a)—and yet they are permitted to deduct all interest paid in carrying such securities.

CONCLUSION.

We respectfully submit:

(1) That the additional tax sought to be imposed is in purpose and effect a tax, not upon income, but upon interest paid by dealers in purchasing and carrying state and municipal bonds for distribution to investors.

(2) That it is a direct and discriminative burden upon the instrumentalities of the states and, if

authorized by the law, would be unconstitutional.

(3) That the tax is not authorized by the law; the deduction of interest paid by dealers is permitted by paragraph (1) of Section 214 (a); any doubt must be resolved in favor of the taxpayer; and the Court will if possible construe the act to avoid the serious constitutional question presented by respondent.

FRED H. DAVIS,
Attorney General of the State of Florida.
ROBERT R. REED,
Counsel for George B. Gibbons and Company, Inc.,

IN THE

Court of Claims of the United States

No. L-422.

GEO. B. GIBBONS & CO. INC., a corporation,
against
THE UNITED STATES OF AMERICA.

PETITION.

(Filed October 14, 1930.)

To the Court of Claims of the United States:

The petitioner, Geo. B. Gibbons & Co. Inc., hereinafter called the claimant, respectfully shows:

1. At all times hereinafter named, the claimant was and is a domestic corporation organized and existing under the laws of the State of New York engaged in the business of investment banking, being the original purchase of bonds and notes issued by states or their political subdivisions and the resale and distribution of such securities to their customers and having an office and principal place of business at 40 Wall

Street, Borough of Manhattan and City of New York, except that since May 1st, 1929, claimant's office has been and now is at 49 Wall Street, in such Borough and City.

2. To secure the additional capital necessary to purchase such securities and to carry them pending their sale, the claimant in its regular course of business, and according to the regular course of business of all dealers in such securities, borrows a large amount of money from one or more banks and deposits with such banks the securities which it has purchased and is holding for sale, increasing or diminishing such loans from time to time as securities are purchased and sold, and is required to pay interest on such loans according to the rates prevailing from time to time and charged to it by such banks.

3. During the calendar years 1926, 1927 and 1928, respectively, the claimant paid as interest on such loans, being interest paid to purchase and carry obligations issued by states and their political subdivisions pending the sale thereof, as aforesaid, which obligations were purchased by claimant and thereafter resold by it, the following sums:

1926, $64,723.49, being at the average rate of 4.51 per centum per annum,
1927, $52,836.82, being at the average rate of 4.22 per centum per annum,
1928, $50,596.85, being at the average rate of 5.12 per centum per annum,

That all of said moneys were paid by claimant in the ordinary and necessary course of its business and con-

stituted ordinary and necessary expenses of such business. That none of such obligations were purchased or carried by claimant for investment or otherwise than as stated, to wit: for sale in the course of the claimant's business.

4. That thereafter and in due course the claimant made its income tax return for each of said years and in determining its net income the claimant deducted the ordinary and necessary expenses of its business, including the amounts so paid as interest in carrying such securities. Such deductions were made under the Revenue Act of 1926, paragraph (1) of subsection (a) of Section 234, and under the Revenue Act of 1928, paragraph (a) of Section 23.

5. That thereafter upon the audit of the claimant's said income tax returns, the Commissioner of Internal Revenue erroneously and illegally assessed the claimant an additional tax for each of said years, to wit: for the taxable year 1926 (excluding a small amount based on other grounds which claimant has waived) $8,966.31 with interest, for the taxable year 1927 $7,402.97 with interest, and for the taxable year 1928 $1,431.38. Such amount in each case being the amount of additional tax, with interest, which would have been due by claimant if the claimant's net income had been increased by the amount of interest which it had paid as above stated and such additional assessment in each case was based solely on the elimination by the Commissioner of the deduction of interest paid by claimant for the years and in the amounts above named to purchase and carry obligations issued by states and their political subdivisions, even though

as stated such payments were made in each instance as an ordinary and necessary expense of claimant's business under the above recited paragraphs and provisions of the Revenue Acts of 1926 and 1928. The Commissioner claiming that such deductions even though made under the paragraphs and provisions above recited as a part of the expenses of claimant's business were in some way or for some reason affected by the restriction or exception to the deduction of interest when claimed under paragraph (2) of subsection (a) of Section 234 of the Revenue Act of 1926 or paragraph (a) of Section 23 of the Revenue Act of 1928, though claimant during said years neither borrowed money nor paid interest outside of its trade or business and therefore had no occasion to make or claim any deduction of interest under the last recited paragraphs. Claimant simply followed the order and natural reading of the law and deducted all its business expenses under the paragraphs relating to such expenses. It made or claims no deduction under the later paragraphs. Nowhere in such Acts, or either of them, is there any restriction or limitation to the deduction of ordinary and necessary expenses of the business, otherwise the tax would rest upon the gross receipts or turnover of a mercantile business and as claimant is advised, would not be valid as an income tax, nor would the amount so determined be within the definition of gross income as found in Section 22 (a) or within the terms or intent of the above recited Revenue Acts.

6. The taxpayer was and is a dealer in state and municipal securities. Substantially all of the obligations issued by states and municipalities are sold to

dealers in such securities, generally on competitive bidding and are taken up and carried by the dealers until they are retailed to their customers. All such dealers as a matter of practice and necessity borrow the larger part of the moneys used by them to purchase and carry such securities. Such money is necessarily borrowed from the banks at current rates. Such loans are short time or call loans and the interest rate has no direct market relation to the rates paid on the securities carried. To prohibit the deduction of interest paid by dealers in carrying such securities for resale, imposes a direct and serious burden on the purchase and sale thereof by the dealers and this burden substantially reduces the prices paid by dealers for such securities and materially impairs the power of states and municipalities to sell their bonds. This burden becomes very marked in periods of high money rates when dealers hesitate to purchase such obligations and even withdraw from competition in the purchase thereof because of such high rates and because they are in effect taxed upon the amount of interest paid. A corporate dealer having in fact no profit for the taxable year is taxed 13½ per cent on say $500,000 paid in carrying tax exempt securities. He may have received $300,000 or $400,000 tax-free interest on such securities. Dealers buy and sell such obligations for the profit and the profit on the resale thereof is held to be taxable. The interest paid to purchase and carry the obligations is paid as an expense of the business in order to realize such taxable profit.

The taxpayer claims (1) that the additional assessment imposed upon it in the amounts and for the years stated above is unauthorized by the statute

and (2) that such assessment if authorized is unconstitutional. This assessment, despite its terms, is levied in fact upon the amount of interest paid by the dealer in carrying on his normal business. It imposes a direct, substantial and confiscatory burden on this business. This business is highly competitive. Many active investment dealers enter and leave the municipal business or buy few or many issues, as conditions change. Bonds are often authorized by statute or ordinance to be sold at not less than par bearing a limited rate of interest, and cannot be sold at all if the burdens imposed on the business are such as not to permit their purchase and sale within such limits at a possible profit. In such cases the discriminatory burden on dealers makes it impossible for the states and municipalities to dispose of their bonds and to carry out the governmental object for which such bonds are authorized and in all cases reduces the price of bonds and increases the interest cost of the borrowing and of the object for which the bonds are authorized. The tax itself is shifted to the states and their political subdivisions. Correspondingly whatever benefit there may be in the fact that the interest received on such securities is tax exempt to the dealers is received by the states and municipalities which issue them. The burden or benefit, varying with the market, is that of the governmental interests and functions affected.

7. That for the taxable year 1928 the petitioner received interest on obligations issued by states and municipalities which obligations were purchased with the money borrowed as aforesaid only the sum of $41,011.09, being at the average rate of 4.15 per cent,

and paid interest to carry such obligations in the sum of $50,596.85. Excluding the interest received as aforesaid the petitioner reported a net loss for such year of $35,668.68. Including such interest, it had in fact a net income of $5,342.41 which, less the $3,000 credit, would if taxable have been taxed in the sum of $281.09. The Commissioner eliminated the deduction of $50,596.85 representing interest paid and found and taxed as net income the sum of $14,928.17, which, less the $3,000 credit, makes the tax paid by petitioner $1,431.38, an amount exceeding by $1,250.29 the tax which it would have paid had the interest received on such obligations been included as gross income. That such tax is not on net income because there was none. That it is not upon gross income because the selling price of merchandise is in no legal sense gross income to a merchant. That under the law, as interpreted and enforced, by the Commissioner such tax paid for the year 1928, as well as the similar tax for the years 1926 and 1927 as above recited, is a tax on the interest paid by a dealer in carrying such obligations for sale and as such is unconstitutional as a burden on the instrumentalities of a state and as a direct tax made without apportionment. It is also, as petitioner is advised and believed, not within the intent of the act, the dominant purpose of which is to tax net income and in the case of a trade or business to permit the deduction of all ordinary and necessary expenses for the purpose of determining such income.

8. That such tax imposed on dealers in carrying such obligations for sale is further discriminatory and burdensome on the marketing of such obligations

and on the instrumentalities of the states and their subdivisions in that it singles out such obligations for such burden and in particular that no such burden or restriction is imposed on the purchasing and carrying of other obligations issued by railroads and industrial corporations or of preferred and common stocks, although in the case of stocks, the income derived therefrom in the form of dividends is wholly exempt from taxation when received by a corporate dealer, such as the petitioner, and is exempt from the normal tax when received by an individual.

9. The Commissioner duly demanded the payment of such additional tax, which demand was made in due form of law, and the claimant, being advised and believing that its property would be seized if it failed to pay upon such demand, paid the same under protest, to wit: on April 21st, 1930, the claimant under compulsion as aforesaid paid to the Collector of Internal Revenue for the Second New York District of New York City, N. Y., the sum of $10,566.36, as an additional income tax for the year 1926, being $8,966.31 with interest to such date, the sum of $8,279.87, as an additional income tax for the year 1927, being $7,402.97 with interest to such date, and the sum of $1,515.05, as an additional income tax for the year 1928, being $1,431.38 with interest to such date, such additional tax in each of said years being based solely on the elimination of the deductions claimed by claimant representing interest paid as an ordinary and necessary expense of claimant's business, as above recited, although on such date claimant paid or had paid his income taxes for each of such years in full and owed no additional tax

whatsoever. That the said Collector, as claimant is advised and believes, turned over said moneys in due course of official business and deposited the same in the Treasury of the United States of America.

10. Thereafter in due form as permitted by law, claimant on May 5th, 1930, filed with the said Collector a claim for the refund of the amounts so paid, to wit: $10,566.36 for the year 1926, $8,279.87 for the year 1927 and $1,515.05 for the year 1928, paid on April 21st, 1930, which claim for refund set forth the facts substantially as above recited and duly demanded the refund of the illegal payments made as aforesaid. Thereafter in due form of law the said Collector on July 25, 1930, rendered his decision disallowing such claim for refund and so notified claimant.

11. No other action than as aforesaid has been had on this claim in Congress or by any of the Departments. The claimant has at all times borne true allegiance to the Government of the United States. It has not in any way voluntarily aided, abetted, or given encouragement to rebellion against such Government. It is and always has been the sole and absolute owner of the claim here presented. It has made no transfer or assignment of said claim or of any part thereof or of any interest therein. It is justly entitled to the amount claimed from the United States of America, after allowing all just credits and set-offs.

12. The claimant believes the facts as hereinabove stated to be true.

WHEREFORE, the claimant prays judgment against the United States of America upon the facts and law for $20,361.28, together with interest thereon from April 21st, 1930, and its reasonable costs and disbursements herein.

GEORGE B. GIBBONS & COMPANY, INC.,
Claimant.

By GEORGE B. GIBBONS,
As its President.

JOHN E. WALKER,
Attorney for Claimant.

State of New York, County of New York, ss.:

GEORGE B. GIBBONS, being duly sworn, deposes and says:

I am the President of George B. Gibbons & Company, Inc., the claimant above named. I am well acquainted with its business. I have read the foregoing petition and know its contents. The same is true of my own knowledge except as to the matters therein stated upon information and belief and as to those matters I believe it to be true.

GEORGE B. GIBBONS.

Subscribed and sworn to before me, this 6th day of October, 1930.

H. L. DIETZ,
Notary, Public, Westchester County.

Certificate filed in New York County.
New York Co. Clerk's No. 428.
Commission expires March 30, 1932.

SUPREME COURT OF THE UNITED STATES.

No. 60.—October Term, 1930.

F. G. Denman, Administrator of Charles H. Nauts, Collector of Internal Revenue, Petitioner, vs. W. L. Slayton.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit.

[February 24, 1931.]

Mr. Justice McReynolds delivered the opinion of the Court.

During the year 1922 while respondent Slayton engaged in the business of buying, carrying and selling tax exempt municipal bonds he collected $65,720.06 as interest on securities of that character which he owned. He paid out $78,153.84 for interest on money borrowed by himself in due course for the purpose of purchasing and carrying exempt securities. In his return showing income received during that year he excluded the interest so collected, and he claimed deduction for the interest paid out on the borrowed money. The Commissioner disallowed the deduction and made a corresponding additional assessment. Respondent paid the sum demanded thereunder and after proper preliminary action sued to recover it.

Determination of the question involved must turn upon the validity, construction and effect of Sections 213 and 214, Revenue Act of 1921, 42 Stat. 227, 237, 238, 239. Their pertinent provisions follow:

> Sec. 213. That for the purposes of this title . . . the term "gross income" . . .
>
> (b) Does not include the following items, which shall be exempt from taxation under this title:
>
> 1. Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia;
>
> Sec. 214. (a) That in computing net income there shall be allowed as deductions . . .